Sacrificing To Restore Market Confidence

By Charles T. Munger

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Our situation is dire. Moderate booms and busts are inevitable in free-market capitalism. But a boom-bust cycle as gross as the one that caused our present misery is dangerous, and recurrences should be prevented. The country is understandably depressed -- mired in issues involving fiscal stimulus, which is needed, and improvements in bank strength. A key question: Should we opt for even more pain now to gain a better future? For instance, should we create new controls to stamp out much sin and folly and thus dampen future booms? The answer is yes.

Sensible reform cannot avoid causing significant pain, which is worth enduring to gain extra safety and more exemplary conduct. And only when there is strong public revulsion, such as exists today, can legislators minimize the influence of powerful special interests enough to bring about needed revisions in law.

Many contributors to our over-the-top boom, which led to the gross bust, are known. They include insufficient controls over morality and prudence in banks and investment banks; undesirable conduct among investment banks; greatly expanded financial leverage, aided by direct or implied use of government credit; and extreme excess, sometimes amounting to fraud, in the promotion of consumer credit. Unsound accounting was widespread.

There was also great excess in highly leveraged speculation of all kinds. Perhaps real estate speculation did the most damage. But the new trading in derivative contracts involving corporate bonds took the prize. This system, in which completely unrelated entities bet trillions with virtually no regulation, created two things: a gambling facility that mimicked the 1920s "bucket shops" wherein bookie-customer types could bet on security prices, instead of horse races, with almost no one owning any securities, and, second, a large group of entities that had an intense desire that certain companies should fail. Croupier types pushed this system, assisted by academics who should have known better. Unfortunately, they convinced regulators that denizens of our financial system would use the new speculative opportunities without causing more harm than benefit.

Considering the huge profit potential of these activities, it may seem unlikely that any important opposition to reform would come from parties other than conventional, moneyed special interests. But many in academia, too, will resist. It is important that reform plans mix moral and accounting concepts with traditional economic concepts. Many economists take fierce pride in opposing that sort of mixed reasoning. But what these economists like to think about is functionally intertwined, in complex ways, with what they don't like to think about. Those who resist the wider thinking are acting as engineers would if they rounded pi from 3.14 to an even 3 to simplify their calculations. The result is a kind of willful ignorance that fails to understand much that is important.

Moreover, rationality in the current situation requires even more stretch in economic thinking. Public deliberations should include not only private morality and accounting issues but also issues of public morality, particularly with regard to taxation. The United States has long run large, concurrent trade and fiscal deficits while, to its own great advantage, issuing the main reserve currency of a deeply troubled and deeply interdependent world. That world now faces new risks from an expanding group of nations possessing nuclear weapons. And so the United States may now have a duty similar to the one that, in the danger that followed World War II, caused the Marshall Plan to be approved in a bipartisan consensus and rebuild a devastated Europe.

The consensus was grounded in Secretary of State George Marshall's concept of moral duty, supplemented by prudential considerations. The modern form of this duty would demand at least some increase in conventional taxes or the imposition of some new consumption taxes. In so doing, the needed and cheering economic message, "We will do what it takes," would get a corollary: "and without unacceptably devaluing our money." Surely the more complex message is more responsible, considering that, first, our practices of running twin deficits depend on drawing from reserves of trust that are not infinite and, second, the message of the corollary would not be widely believed unless it was accompanied by some new taxes.

Moreover, increasing taxes in some instances might easily gain bipartisan approval. Surely both political parties can now join in taxing the "carry" part of the compensation of hedge fund managers as if it was more constructively earned in, say, cab driving.

Much has been said and written recently about bipartisanship, and success in a bipartisan approach might provide great advantage here. Indeed, it is conceivable that, if legislation were adopted in a bipartisan way, instead of as a consequence of partisan hatred, the solutions that curbed excess and improved safeguards in our financial system could reduce national pain instead of increasing it. After the failure of so much that was assumed, the public needs a restoration of confidence. And the surest way to gain the confidence of others is to deserve the confidence of others, as Marshall did when he helped cause passage of some of the best legislation ever enacted.

Creating in a bipartisan manner a legislative package that covers many subjects will be difficult. As they work together in the coming weeks, officials might want to consider a precedent that helped establish our republic. The deliberative rules of the Constitutional Convention of 1787 worked wonders in fruitful compromise and eventually produced the U.S. Constitution. With no Marshall figure, trusted by all, amid today's legislators, perhaps the Founding Fathers can once more serve us.

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